



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Number: **200849017**
Release Date: 12/5/2008

Date: September 10, 2008

Uniform Issue Number:
501.03-00, 509.01-01

Contact Person:

Identification Number:

Contact Number:

Employer Identification Number:

Form Required To Be Filed:
Form 1120
Tax Years:
All

SE:T:EO:RA:T:3

Dear :

This is our final determination that you do not qualify for exemption from Federal income tax as an organization described in Internal Revenue Code section 501(c)(3). Recently, we sent you a letter in response to your application that proposed an adverse determination. The letter explained the facts, law and rationale, and gave you 30 days to file a protest. Since we did not receive a protest within the requisite 30 days, the proposed adverse determination is now final.

Because you do not qualify for exemption as an organization described in Code section 501(c)(3), donors may not deduct contributions to you under Code section 170. You must file Federal income tax returns on the form and for the years listed above within 30 days of this letter, unless you request an extension of time to file. File the returns in accordance with their instructions, and do not send them to this office. Failure to file the returns timely may result in a penalty.

We will make this letter and our proposed adverse determination letter available for public inspection under Code section 6110, after deleting certain identifying information. Please read the enclosed Notice 437, *Notice of Intention to Disclose*, and review the two attached letters that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437. If you agree with our deletions, you do not need to take any further action.

In accordance with Code section 6104(c), we will notify the appropriate State officials of our determination by sending them a copy of this final letter and the proposed adverse letter. You should contact your State officials if you have any questions about how this determination may affect your State responsibilities and requirements.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter. If you have any questions about your Federal income tax status and responsibilities, please contact IRS Customer Service at 1-800-829-1040 or the IRS Customer Service number for businesses, 1-800-829-4933. The IRS Customer Service number for people with hearing impairments is 1-800-829-4059.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437
Redacted Proposed Adverse Determination Letter
Redacted Final Adverse Determination Letter



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Date: March 31, 2008

Uniform Issue List No.:
501.03-00
509.02-02

Contact Person:

Identification Number:

Contact Number:

FAX Number

Employer Identification Number:

Legend:

L =
M =
N =
O =
P =
Q =
R =
S =
T =
U =
W =

X =
XX =
XXX =
4X =
5X =

Dear :

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. We have separately considered whether you qualify as a supporting organization under section 509(a)(3). Based on the information submitted, we have concluded that you do not qualify as a supporting organization under section 509(a)(3). The basis for our conclusion is set forth below.

Section 501(c)(3)**INTRODUCTION**

You were incorporated in the state of M on N. Your articles state that you are organized exclusively for charitable, scientific, literary and educational purposes within the meaning of section 501(c)(3) of the Code. You are also formed to benefit, perform the functions of, or carry out the purpose of L, an organization that is described in section 501(c)(3) and 509(a)(1) of the Code. L is your sole member.

You filed your Form 1023, Application for Recognition of Exemption. In your application, you state that your donor, O, invented and patented a number of inventions, including P. O plans to license the patent on P to L, your sole member. A Memorandum of Understanding between O and L provides that L may assign to you all of its patent rights and obligations under the contract. Once the patent on P has been developed, L will assign the patent to others for a fee. You will receive a portion of the patent fees. You state that you will use the income to conduct research and develop other products and ideas that you believe will be beneficial to the environment. The architecture and design of anything invented by you will be available to the public.

Agreement

As stated above, O and his wife entered into a Memorandum of Understanding and License of Patents (MOU) with L. The MOU provides that O shall oversee the development of the prototype engine that can be tested in W. L will reimburse O for his actual expenses, including the reasonable salaries of persons working with or for him (but not of O himself), that are necessary to develop the prototype and that are consistent with the budget presented to L. Payments from L under the MOU shall not exceed \$XX without the approval of L. O will submit invoices to L and L will timely pay O and other contractors working on the project.

Under the MOU, O grants to L an exclusive, irrevocable, and worldwide license with right to sublicense third parties. In consideration for the license, the MOU provides that L shall compensate O as follows:

A. L shall pay to O \$XXX on the signing of the MOU, and \$XXX for the first three quarters thereafter.

B. L shall pay to O an amount that shall not exceed 4X, payable entirely out of 50 percent of the first \$5X in income that L receives from the sublicense of the patents. L may terminate its obligation to pay prior to the payment of the full \$4X for any reason. In the event of termination when the prototype is still being completed, L shall reimburse O only for costs that he incurred up to the date that is fifteen days following the date of

notice of termination. O may terminate the MOU, including but not limited to the license, only if L breaches its obligations to make payments to O when due. On the death of O and his wife, the patents shall transfer free and clear to L. In the event that L has paid at least \$X in income from the patent license, L shall have no further obligation to pay any royalties to O and his wife, or their heirs, estate, administrators, executors, creditors, successors, or assigns, even if the full amount of the income contemplated have not yet been paid. In the event that L has not paid at least \$X in income to the donors, L shall continue to make payments until L has paid them \$X. If O and his wife fail to amend their wills or living trusts to ensure that the patents transfer free and clear to L, L will have no obligation to pay \$X.

Most importantly, the MOU provides that L may assign to you all of its rights and obligations under the contract. According to the MOU, O consents to cooperate with L in facilitating such assignment, as needed.

509(a)(3) Supporting Organization

Your bylaws provide that the L shall be your sole member with the power to elect your board members. L also has the power to remove any director from your board with or without cause. Upon the resignation or dissolution of the member, your Board of Directors shall serve as the sole member. Directors shall serve for a term of three years and may serve an unlimited number of consecutive terms. O and one other individual on the board are "disqualified persons". You do not have a conflict of interest policy. Your board expects to meet at least once a year, although special meetings may be called by the chair, president, or any two directors.

You plan to raise funds from gifts, grants from private foundations and individuals and corporate contributions. You may engage in lobbying activities in the future, but you state that you will adhere to the spending limitations set in section 501(h) of the Code. You have not yet solicited contributions.

You have not engaged in any activities. You are not a party to any contracts. You have no assets and no income or expenses, pending receipt of a letter determining your exempt status. Initially, your board was appointed by your sole corporate member, L. However, your board of directors will make all decisions in connection with your operations, investments, and grants.

Under your bylaws, L elects your directors every three years. Your bylaws state that the board of directors shall meet at least once a year. Annual meetings of the board shall be called by the president. Special meetings may be called by the chair, president, or any two directors. The chair of the board and other key officers help formulate the

agenda for the meetings. O, the donor, will have only one of five seats on the board of the institute.

Q, one of the directors, has not done any work for O. Q has done accounting work for R, president of L, who is also one of your directors. No directors have done work for O. Q is treasurer of L. O is your board chairman and president. S is vice chair, T is secretary and R is assistant secretary. Each officer is authorized to act as sole signatory on your account(s) established at one or more financial institutions selected by the treasurer in consultation with the president. Each officer is also authorized to sign contracts on your behalf.

Law:

Section 501(a) of the Code provides, in part, that organizations described in section 501(c) are exempt from federal income tax. Section 501(c)(3) of the Code describes, in part, an organization that is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(a)(1) of the Income Tax Regulations provides that in order for an organization to be exempt under section 501(c)(3) of the Code it must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational or operational test, it is not exempt.

Section 1.501(c)(3)-1(b)(4) provides that an organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. An organization's assets will not be considered to meet the organizational test if its articles or law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.

Section 1.501(c)(3)-1(c)(1) of the regulations provides that an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized exclusively for any of the purposes specified in section 501(c)(3) unless it

serves public rather than private interests. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled directly or indirectly, by such private interests.

In Better Business Bureau v. United States, 326 U.S. 279 (1945), the Supreme Court stated that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under section 501(c)(3) of the Code, regardless of the number or importance of statutorily exempt purposes. Thus, the operational test standard prohibiting a substantial nonexempt purpose is broad enough to include inurement, private benefit, and operations that further nonprofit goals outside the scope of section 501(c)(3).

Rev. Rul. 61-170, 1961-2 C.B. 112, holds that a nurses' association which maintained an employment registry primarily for the employment of its members was not entitled to exemption under section 501(c)(3).

Rev. Rul. 65-1, 1965-1 C.B. 226, holds that an organization whose principal activity was making research grants for the development of new machinery to be used in a particular commercial operation that retained all rights to the new developments that it licensed to certain manufacturers, was not exempt under section 501(c)(3) of the Code.

Rev. Rul. 73-193, 1973-1 C.B. 262 holds that patent development and management service fees deducted by an organization exempt under section 501(c)(3) of the Code from royalties that are collected by it in its capacity as patent manager for the beneficial owners of patents do not retain the character of royalties in the organization's hands for purposes of section 512(b)(2).

Rev. Rul. 81-178, 1981-2 C.B. 135 provides that payments an exempt labor organization receives from various business enterprises for the use of the organization's trademark and similar properties are royalties within the meaning of section 512(b)(2) of the Code and are not taken into account in determining unrelated taxable income. However, payments the organization receives for personal appearances and interviews by its members are not royalties but are compensation for personal services and must be taken into account in computing the organization's unrelated business taxable income.

Analysis and Conclusion:

In order to qualify for exemption under section 501(c)(3) of the Code, you must establish that you are organized and operated exclusively for religious, charitable, or educational purposes and that no part of your net earnings inure to the benefit of a private individual

or shareholder. An organization will not be regarded as being operated exclusively for exempt purposes if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Private benefit has both qualitative and quantitative connotations. In the qualitative sense, to be incidental, the private benefit must be a necessary concomitant of the activity that benefits the public at large, i.e., the benefit to the public cannot be achieved without necessarily benefiting private individuals. See, e.g., Rev. Rul. 70-86, 1970-1 C.B. 128, in which it was found that it would be impossible to accomplish the organization's charitable purposes of cleaning and maintaining a lake without providing benefits to certain private property owners. In the quantitative sense, to be incidental, the benefit to private interests must not be substantial in the context of the overall public benefit conferred by the activity.

To be qualitatively incidental, the private benefit to O must be a necessary concomitant of the activity that benefits the public at large. From the facts you have represented, it appears that your sole activity is to operate in a commercial manner and to employ O. The MOU provides payment for the performance of services by O in developing the engine. The payment may be as much as \$4x. You will be the vehicle for O to complete his work on the patent, for which he will be richly compensated. Based on these facts, your primary purpose is to provide a private benefit for O, rather than to benefit the public. Accordingly, you have not shown that the private benefit is a necessary concomitant of the activity benefiting the public at large and the private benefit is not qualitatively incidental.

In order to be quantitatively incidental, the private benefit must be insubstantial in the context of the overall public benefit. Although you may promote educational purposes by publishing the results of O's research to the public at large, there is no information in the file to indicate if the publication of this material will be made in a timely manner. You are organized and operated primarily to carry on a business that will employ O. O who formerly worked for U, will develop P specifically to be tested in a U vehicle. O will be richly rewarded for his services. No benefit will accrue to the public charity until O completes the development of the patent on P. When measured in the context of the overall public benefit conferred, this private benefit is not insubstantial. Therefore you are not operated exclusively for exempt purposes under the regulations.

Secondly, section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest.

Section 1.501(c)(3)-1(d)(5) of the Regulations provides, in part, that the term "scientific," as used in section 501(c)(3) of the Code, includes the carrying on of scientific research in the public interest. For research to be scientific within the meaning of section 501(c)(3), it must be carried on in furtherance of a scientific purpose. Scientific

research does not include activities of a type ordinarily carried on as an incident to commercial or industrial operations, as, for example, the ordinary testing of materials or products or the designing or construction of equipment or buildings.

Like the organization in Rev. Rul. 65-1, supra, your primary activity of developing machinery to be used by a commercial operation does not constitute scientific research. Furthermore, the development of a new machine, the patents of which may be licensed to selected manufacturers, is directed toward benefiting those particular manufacturers and therefore, the benefit to the public must be considered indirect.

Accordingly, you are not operated for a public purpose. Thus, you are not exempt under section 501(c)(3) of the Code.

Section 509(a)(3)

INTRODUCTION

We have also considered your application for supporting organization status (non-private foundation status) under section 509(a)(3) of the Code. We conclude that even if you were exempt under section 501(c)(3), you would be a private foundation under section 509(a). Section 509(a)(3)(A), in effect, describes as a public charity, an organization which is organized and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) and (2).

Section 509(a)(3) of the Code provides that the term "private foundation" does not include an organization which

- (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in section 509(a)(1) or (2),
- (B) is operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2), and
- (C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in section 509(a)(1) or (2).

Section 509(a)(3)(B) of the Code provides that, in order to qualify under section 509(a)(3), an organization must be "operated, supervised, or controlled by," "supervised or controlled in connection with," or "operated in connection with" one or more publicly

supported organizations.

You state that you meet the requirements for section 509(a)(3) as an organization that is "operated, supervised, or controlled by" an organization that is described in section 509(a)(1) or (2).

Section 1.509(a)-4(g)(1) of the Income Tax Regulations provides that an "operated, supervised, or controlled by" relationship is established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations. Each of the items "operated by," "supervised by," and "controlled by," as used in section 509(a)(3)(B), presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations. The relationship required under any one of these terms is comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization.

You have failed to establish that you meet the relationship test of section 509(a)(3)(B) of the Code. Although a majority of your trustees are appointed by L, you have not shown that L has a substantial degree of control over your policies, programs, and activities. Therefore, you are not "operated, supervised, or controlled by" the L.

CONTROL TEST:

Disqualified persons (DPs) within the meaning of section 4946 of the Code may exercise control over your organization.

Section 509(a)(3)(C), in effect, provides that public charity status under section 509(a)(3) is precluded for an organization that is controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) and (2).

Section 1.509(a)-4(j)(1) of the regulations provides:

That if a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph, such person will be regarded as a disqualified person rather than as a representative of the publicly supported organization.

An organization will be considered "controlled," for purposes of section 509(a)(3), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This includes, but is not limited to, the right of a substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization.

Thus, if the governing body of a foundation is composed of five trustees, none of whom has veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered controlled, directly or indirectly, by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting right with respect to stocks in which members of the governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

Rev. Rul. 80-207, 1980-2 C.B. 193, held that for purposes of classification as a supporting organization under section 509(a)(3) of the Code, an employee of a corporation owned (over 35 percent) by a substantial contributor, a disqualified person, will be considered under the indirect control of a disqualified person for purposes of the control test.

Rev. Rul. 80-207 provides the following analysis:

Because one of the organization's directors is a disqualified person and neither the disqualified person nor any other director has a veto power over the organization's actions, the organization is not directly controlled by a disqualified person under section 1.509(a)-4(j) of the regulations. However, in determining whether an organization is indirectly controlled by one or more disqualified persons, one circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons.

A disqualified person is in a position to control the Board, directly or indirectly, because O has control over any patents that you produce. O also controls development of the product that will be your primary asset. You have no assets or income except for the income or benefit achieved by O's work. For these reasons, O

may indirectly influence your board of directors.

Accordingly, your organization is controlled by disqualified persons within the meaning of section 509(a)(3)(C) of the Code, and fails to qualify under the control test.

Alternative Rationale for Denial of Exemption and Public Charity Status

Your relationship with L does not fit the relationship contemplated in section 509(a)(3) but, rather contemplates a business relationship between you, O and L, which relationship is that of joint venture or partnership with respect to the development of a commercial product. Further, your relationship to L is not one that is indicative of a supporting organization or even necessarily a grantmaking relationship. Rather, the relationship is one indicative of a commercial enterprise to develop a product that may be patented and licensed to commercial businesses for substantial fees. Since you are carrying on a substantial non-exempt purpose, you do not satisfy the requirements for exemption under section 501(c)(3) and/or 509(a)(3) of the Code.

Determinations

In summary, you do not qualify for tax exemption as an organization described in section 501(c)(3) of the Code. Nor, separately, are you excluded from private foundation status under section 509(a)(3) of the Code. You must file federal income tax returns.

Contributions to you are not deductible under section 170 of the Code.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies. Section 7428(b)(2) of the Code provides, in part, that a declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

In the event this ruling becomes final, it will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

If you decide to protest this ruling, your protest statement should be sent to the address shown below. If it is convenient, you may fax your reply using the fax number shown in the heading of this letter. If you fax your reply, please contact the person identified in the heading of this letter by telephone to confirm that your fax was received.

Internal Revenue Service

1111 Constitution Ave, N.W.
Washington, D.C. 20224

If you do not intend to protest this ruling, and if you agree with our proposed deletions as shown in the letter attached to Notice 437, you do not need to take any further action.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Robert Choi
Director, Exempt Organizations
Rulings & Agreements

Enclosure
Notice 437